The Institute of Chartered Accountants in England and Wales

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Workbook

For exams in 2021

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Financial Management

The Institute of Chartered Accountants in England and Wales

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Contents

Questions within the Workbook should be treated as preparation questions, providing you with a firm foundation before you attempt the exam-standard questions. The exam-standard questions are found in the Question Bank.

Welcome to ICAEW

I'd like to personally welcome you to ICAEW.

In a fast-changing and volatile world, the role of the accountancy profession has never been more important.

As an ICAEW Chartered Accountant, you will make decisions that will define the future of global business.

By choosing our world-leading chartered accountancy qualification, the ACA, you will acquire exceptional knowledge and skills – with technology and ethics at the heart of your learning. A focus on capabilities such as judgement and scepticism will enable you to make the right decisions in diverse and often complex environments.

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I wish you the best of luck with your studies.

Michael Izza

Chief Executive

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Financial Management

If you are studying this exam as part of the ACA qualification go to icaew.com/examresources or if you are studying the ICAEW CFAB qualification go to icaew.com/cfabstudents.

Module aim

Financial Management enables students to recommend relevant options for financing a business, recognise and manage financial risks and make appropriate investment decisions.

On completion of this module, students will be able to:

- identify capital requirements of businesses, assess financing options and recommend relevant methods of financing;
- identify the financial risks facing a business and the principal methods of managing those risks; and
- apply appropriate investment appraisal techniques taking into account other factors affecting investment decisions.

Method of assessment

The Financial Management module exam is 2.5 hours long. The exam consists of three questions. Managing financial risk will be assessed as a discrete topic. The other two questions will assess financing options and investment decisions and valuation either as discrete or integrated topics.

Specification grid

This grid shows the relative weightings of subjects within this module and should guide the relative study time spent on each. Over time the marks available in the assessment will equate to the weightings below, while slight variations may occur in individual assessments to enable suitably rigorous questions to be set.

	Weighting (%)
1 Financing options	35
2 Managing financial risk	30
3 Investment decisions and valuation	35

Permitted texts

At the Professional and Advanced Levels there are specific texts that you are permitted to use during your exam. All information for these texts is available on icaew.com/permittedtexts.

Professional level exams	**Permitted text**
Audit and Assurance	✔
Financial Accounting and Reporting	✔
Tax Compliance	✔
Business Strategy and Technology	x
Financial Management	x
Business Planning	No restrictions

Advanced Level exams	
Corporate Reporting	No restrictions
Strategic Business Management	No restrictions
Case Study	No restrictions

The exams which have no restrictions include the following:

- Business Planning: Banking;
- Business Planning: Insurance;
- Business Planning: Taxation;
- Corporate Reporting;
- Strategic Business Management; and
- Case Study.

This information, as well as what to expect and what is and is not permitted in each exam is available in the Instructions to Candidates. You will be sent the instructions with your exam admission details. They can also be viewed on our website at icaew.com/exams.

Key resources

Whether you're studying the ACA qualification with an employer, at university, independently (self-studying), or as part of an apprenticeship, we provide a wide range of resources and services to help you in your studies.

Take a look at the online exam resources available to you on icaew.com/examresources and discover more resources and services at icaew.com/studentbenefits.

Syllabus, skills development and technical knowledge grids

This syllabus presents the learning outcomes for each exam and should be read in conjunction with the relevant technical knowledge grids and, where applicable, the skills development grids.

Exam support

A variety of exam resources and support have been developed on each exam to help you on your journey to exam success. This includes exam guidance, sample exams, hints and tips from examiners and tutors, on-demand webinars and articles.

Past exams and mark plans

Use past exams to practise answering questions. The mark plans will help you check your answers. The past exams and mark plans are included in your Question Bank and have been updated to reflect the 2021 legislation and syllabus.

Errata sheets

These documents will correct any omissions within the learning materials once they have been published. You should refer to them when studying.

Exam software

It is vital that you are familiar with the exam software before you take your exam. Access a variety of resources, including the practice software and sample exams at icaew.com/studentresources.

Student support team

Our student support team is here to help and advise you, so do not hesitate to get in touch. Email studentsupport@icaew.com or call +44 (0)1908 248 250. If you are browsing our website, look out for the live help boxes. You will be able to speak directly to an adviser. Mia, our ChatBot, is also on hand to answer your queries.

Online student community

The online student community is the place where you can post your questions and share your study tips. Join the conversation at icaew.com/studentcommunity.

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You'll find new-look features, interviews and guides giving you fresh insights, innovative ideas and an inside look at the lives and careers of our ICAEW students and members. No matter what stage you're at in your journey with us, you'll find content to suit you.

Tuition

The ICAEW Partner in Learning scheme recognises tuition providers who comply with our core principles of quality course delivery. If you are not receiving structured tuition and are interested in doing so, take a look at ICAEW recognised Partner in Learning tuition providers in your area at icaew.com/dashboard.

CABA

It can be tough juggling your studies with work, planning for the future and finding time to unwind. CABA are an independent charity that supports the well-being of the chartered accountant community. So, if you need support at home or at work, CABA is there for you. They provide information, advice and lifelong support to ACA students across the world face-to-face, over the phone and online. All their services are completely free and strictly confidential. Find out more at caba.org.uk.

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Skills within the ACA

Professional skills are essential to accountancy and your development of them is embedded throughout the ACA qualification.

The level of competency required in each of the professional skills areas to pass each module exam increases as ACA trainees progress upwards through each Level of the ACA qualification. The skills progression embedded throughout the ACA qualification ensures ACA trainees develop the knowledge and professional skills necessary to successfully operate in the modern workplace and which are expected by today's forward-thinking employers.

The following professional skills areas are present throughout the ACA qualification.

Skill area	Overall objective
Assimilating and using information	Understand a business or accounting situation, prioritise by determining key drivers, issues and requirements and identify any relevant information.
Structuring problems and solutions	Structure information from various sources into suitable formats for analysis and provide creative and pragmatic solutions in a business environment.
Applying judgement	Apply professional scepticism and critical thinking to identify faults, gaps, inconsistencies and interactions from a range of relevant information sources and relate issues to a business environment.
Concluding, recommending and communicating	Apply technical knowledge, skills and experience to support reasoning and conclusion and formulate opinions, advice, plans, solutions, options and reservations based on valid evidence and communicate clearly in a manner suitable for the recipient.

The following provides further detail on the professional skills that you will develop in this particular module. To see the full skills development grids, please go to icaew.com/examresources.

Assimilating and using information

Understand the situation and the requirements

- Demonstrate understanding of the business context
- Recognise new and complex ideas within a scenario
- Identify the needs of customers and clients
- Explain different stakeholder perspectives and interests
- Identify risks within a scenario
- Identify elements of uncertainty within a scenario
- Identify ethical issues including public interest and sustainability issues within a scenario

Identify and use relevant information

- Interpret information provided in various formats
- Evaluate the relevance of information provided
- Use multiple information sources
- Filter information provided to identify critical facts

Identify and prioritise key issues and stay on task

- Identify business and financial issues from a scenario
- Prioritise key issues
- Work effectively within time constraints
- Operate to a brief in a given scenario

How skills are assessed: students may be required to:

- absorb and understand both structured and unstructured material; and

- give recommendations based on their understanding and interpretation of the information provided, supported by explanation of the reasoning behind and implications of their recommendations.

Structuring problems and solutions

Structure data

- Structure information from various sources into suitable formats for analysis
- Identify any information gaps
- Frame questions to clarify information
- Use a range of data types and sources to inform analysis and decision making
- Structure and analyse financial and non-financial data to enhance understanding of business issues and their underlying causes
- Present analysis in accordance with instructions and criteria

Develop solutions

- Identify and apply relevant technical knowledge and skills to analyse a specific problem
- Use structured information to identify evidence-based solutions
- Identify creative and pragmatic solutions in a business environment
- Identify opportunities to add value
- Identify and anticipate problems that may result from a decision
- Identify a range of possible solutions based on analysis
- Identify ethical dimensions of possible solutions
- Select appropriate courses of action using an ethical framework
- Identify the solution which is the best fit with acceptance criteria and objectives
- Define objectives and acceptance criteria for solutions

How skills are assessed: students may be required to:

- assimilate significant amounts of information, to analyse it (including quantitative analysis) in a way that demonstrates relevant technical knowledge and to draw and support appropriate conclusions.

Applying judgement

Apply professional scepticism and critical thinking

- Recognise bias and varying quality in data and evidence
- Identify assumptions or faults in arguments
- Identify gaps in evidence
- Identify inconsistencies and contradictory information
- Assess interaction of information from different sources
- Exercise ethical judgement

Relate issues to the environment

- Appreciate when more expert help is required
- Identify related issues in scenarios
- Assess different stakeholder perspectives when evaluating options
- Retain an overview of the business issue or scenario
- Appraise corporate responsibility and sustainability issues
- Appraise the effects of alternative future scenarios
- Appraise ethical, public interest and regulatory issues

How skills are assessed: students may be required to:

- make sense of relatively large volumes of data, making judgments on the relevance of data for use in subsequent calculations and discussions;
- reflect on their calculations and the methodology employed and to identify and discuss the implications of calculations; and

- make and justify judgements based on earlier calculations.

Concluding, recommending and communicating

Conclusions

- Apply technical knowledge to support reasoning and conclusions
- Apply professional experience and evidence to support reasoning
- Use valid and different technical skills to formulate opinions, advice, plans, solutions, options and reservations

Recommendations

- Present recommendations in accordance with instructions and defined criteria
- Make recommendations in situations where risks and uncertainty exist
- Formulate opinions, advice, recommendations, plans, solutions, options and reservations based on valid evidence
- Make evidence-based recommendations which can be justified by reference to supporting data and other information
- Develop recommendations which combine different technical skills in a practical situation

Communication

- Present a basic or routine memorandum or briefing note in writing in a clear and concise style
- Present analysis and recommendations in accordance with instructions
- Communicate clearly to a specialist or non-specialist audience in a manner suitable for the recipient
- Prepare the advice, report, or notes required in a clear and concise style

How skills are assessed: students may be required to:

- recommend suitable courses of action in a given situation (financing decisions, dividend decisions, investment appraisal decisions); and
- incorporate advice within a 'business report' format, addressing both the strengths and weaknesses of any recommendations and/or reasons for the rejection of alternatives.

To help you develop your ability to demonstrate competency in each professional skills area, each chapter of this Workbook includes up to four Professional Skills Guidance points.

Each Professional Skills Guidance point focuses on one of the four ACA Professional Skills areas and explains how to demonstrate a particular aspect of that professional skill relevant to the topic being studied. You are advised to refer back to the Professional Skills Guidance points while revisiting specific topics and during question practice.

Chapter 1

Partnerships

Introduction

Learning outcomes

- Calculate the assessable trading profits or losses of a partnership including after a change in the profit sharing ratio or change in partners, and allocate the profits or losses to each partner including the allocation of notional profits and losses

Specific syllabus reference for this chapter is 5d.

Syllabus links

We covered the basic division of profits between partners in Chapter 7 of your Principles of Taxation Study Manual.

In this chapter, we review that knowledge and look at changes in partnership composition, notional profits and losses and limited liability partnerships.

Examination context

In the examination students may be required to:

- allocate profits and losses between partners in an ongoing partnership, where partners are joining or leaving the partnership or where there is a change in the profit share arrangement
- deal with the allocation of notional profits and losses
- discuss the implication of a limited liability partnership

Better students have achieved excellent marks in partnership questions. Less well prepared students struggle with where to start partnership questions and often try to allocate profits for the tax year rather than for the period of account.

Chapter study guidance

Use this schedule and your study timetable to plan the dates on which you will complete your study of this chapter.

Topic	Practical significance	Study approach	Exam approach	Interactive questions
1 - 2	**Partnerships and Limited liability partnerships** The tax treatment of partnerships is likely to be very relevant to your working life while you are training as many trainees are employed by partnerships. It is an important business structure for many businesses in the UK from builders to professional firms of accountants and lawyers. Allocating a profit or loss between partners	**Approach** Partnerships tend to be a discriminating topic in the exam. If you study them carefully it is often possible to score very high marks on partnership questions. If you do not study them well, you are likely to end up in a muddle and write very confused answers. Section 1 is the most important part of the chapter and should be worked	A partnership could feature within a part of Question 5 in your exam. It allows you to be tested on anything that would feature in a sole trader scenario in addition to the extra complication of allocating the profits between partners. It is also an excellent way that you can be tested on different basis period rules if you have a partner joining or leaving the partnership. It will be vital that you present your answer to	**IQ1: Partner leaving partnership** This question will allow you to allocate a profit out where a partner leaves part way through the year and to then apply basis period rules.

Topic	Practical significance	Study approach	Exam approach	Interactive questions
	will require you to establish the profit-sharing arrangements for the relevant period of account. Sometimes the profit-sharing arrangements involve guaranteed shares of income or partner salaries. This can create a position where some partners appear to have suffered a share of a loss, when in fact the partnership as a whole has made a profit. There are special rules for reallocating these notional losses.	through carefully. Section 2 can be read more quickly to ensure you have an awareness of the material covered but work though the worked example. **Stop and think** Have you ever wondered how partnerships differ from sole trader businesses? How are shared profits taxed especially when there are changes in the partnership?	a partnership question clearly, ensuring you set out which period or tax year and which partner you are considering.	

1 Partnerships

Section overview

- A partnership itself is not a taxable person.
- Each partner is liable to income tax on his share (and only his share) of the partnership taxable trading income. Similarly, each partner is liable to capital gains tax on his share of any gains realised on the disposal of partnership assets.
- The current year basis applies to continuing partnerships.
- Opening and closing year rules apply to partners who join and leave the partnership but the continuing partners remain on the current year basis.
- If the allocation of partnership profit results in a notional loss for one or more partners, a reallocation of profits must be made.
- Similarly, if the allocation of partnership loss results in a notional profit for one or more partners, a reallocation of the loss must be made.
- Loss relief is available for each partner depending on his own circumstances.

2.1 Taxation of partnerships

A partnership itself is not a taxable person. Each of the partners is liable to tax on his share of the taxable trading income of the partnership on the same basis as a sole trader.

For income tax purposes in a continuing partnership, the basis of assessment for a tax year is the current year basis. Opening and closing year rules apply as partners join and leave the partnership.

Each partner is only liable to income tax on his share of the partnership trading income.

2.2 Allocation of partnership profits

The net profit or loss for the partnership for the period of account must be adjusted for tax purposes (in the same way as for a sole trader as we saw in Chapter 6). Partners' salaries and interest on capital are not deductible expenses and must be added back in computing profits, because they are a form of drawings.

Capital allowances for the partnership must then be computed and deducted from the adjusted trading profit. Capital allowances are available on partnership assets and are computed as for a sole trader (see Chapter 7).

The resultant taxable trading income of the partnership for the period of account is allocated between the partners according to the profit-sharing agreement for the period of account.

The agreement may specify that one or more of the partners is entitled to a 'salary' (an allocation of profits) and/or interest on capital introduced into the partnership. These amounts are allocated first and then the remaining amount of taxable trading income is allocated in accordance with the agreed profit-sharing ratios (PSR).

2.3 Change in profit sharing ratio during period of account

Where there is a change in the profit-sharing agreement during the period of account, divide the period of account into the periods of the different profit-sharing agreements.

Any salaries and interest on capital as appropriate must be time-apportioned accordingly.

Worked example: Change in partnership profit allocation

Lisa, Alicia and Mary are in partnership. Partnership accounts are made up to 31 July. The partnership had taxable trading income of £90,000 for the year ended 31 July 2020.

Until 30 November 2019, the partnership had shared profits equally. From 1 December 2019 it was agreed that the partners should be paid an annual salary and the profit-sharing ratios divided as follows:

	Lisa	Alicia	Mary
Salary	£24,000	£21,000	£15,000
PSR	25%	35%	40%

Requirement

Show the taxable trading income for each partner for the period of account.

Solution

	Total	Lisa	Alicia	Mary
	£	£	£	£
First PSR period				
1.8.19 to 30.11.19				
PSR (1:1:1)				
£90,000 × 4/12	30,000	10,000	10,000	10,000
Second PSR period				
1.12.19 to 31.7.20				
Salaries (× 8/12)	40,000	16,000	14,000	10,000
PSR (25:35:40)	20,000	5,000	7,000	8,000
Total	90,000	31,000	31,000	28,000

2.4 Partner joining partnership

If a new partner joins a partnership, the opening year rules will apply to that partner, but the continuing partners will continue on the current year basis.

If the new partner joins the partnership part way through the partnership period of account, there will be a change in the partnership profit-sharing agreement. This change is dealt with in the same way as a change in profit-sharing agreement in a continuing partnership.

Remember that when a new partner joins a partnership part way through a period of account, the new partner's period of account will only commence when he joined the partnership and will therefore be a short period.

It is important that you deal with the allocation of profits to each partner first, before you attempt to match those profits to tax years.

Worked example: Partner joining a partnership

Sam and Emma have been in partnership for many years making up accounts to 31 December each year. Profits have been shared equally.

On 1 June 2020, Hilary joined the partnership. From that date, profits were shared Sam 50% and Emma and Hilary 25% each.

The partnership taxable trading income for the year ended 31 December 2020 was £48,000 and for the year ended 31 December 2021 was £60,000.

Requirement

Compute the trading income taxable on Sam, Emma and Hilary for 2020/21.

Solution

First, allocate the taxable trading income between the partners:

y/e 31.12.20	**Total**	**Sam**	**Emma**	**Hilary**
	£	**£**	**£**	**£**
First PSR period				
1.1.20 to 31.5.20 = £48,000 × 5/12				
PSR (1:1)	20,000	10,000	10,000	n/a
Second PSR period				
1.6.20 to 31.12.20 = £48,000 × 7/12				
PSR (50:25:25)	28,000	14,000	7,000	7,000
Totals	48,000	24,000	17,000	7,000

y/e 31.12.21	**Total**	**Sam**	**Emma**	**Hilary**
	£	**£**	**£**	**£**
PSR (50:25:25)	60,000	30,000	15,000	15,000

Next, consider the basis periods for each partner for 2020/21.

Sam

CYB

y/e 31.12.20	£24,000

Emma

CYB

y/e 31.12.20	£17,000

Hilary

First tax year (2020/21)

Actual basis

Basis period 1.6.20 to 5.4.21

	£
1.6.20 to 31.12.20	7,000
1.1.21 to 5.4.21	
3/12 × £15,000	3,750
Total	10,750

2.5 Partner leaving partnership

If a partner leaves a partnership, the closing year rules will apply to that partner, but the continuing partners will continue on the current year basis.

If the partner leaves the partnership part way through the partnership period of account, there will be a change in the partnership profit-sharing agreement, dealt with in the same way as a change in profit-sharing agreement in a continuing partnership.

Again, it is important that you deal with the allocation of profits to each partner first, before you attempt to match those profits to tax years.

Interactive question 1: Partner leaving partnership

Richard, Charlotte and William have traded in partnership for many years. Each partner was entitled to 6% interest per annum on capital introduced into the partnership. Each partner had introduced £100,000 of capital on the commencement of the partnership. Thereafter, profits were shared in the ratio 50% to Richard, 30% to Charlotte and 20% to William. The partnership makes up accounts to 30 September each year.

On 1 May 2020, William left the partnership. Thereafter profits were shared equally between the two remaining partners and no interest was paid on capital. The partnership taxable trading income for the year to 30 September 2020 was £120,000. William had overlap profits on commencement of £5,000.

Requirement

Using the standard format below, compute the taxable trading income for each of the partners for 2020/21.

First allocate the taxable trading income between the partners:

y/e [ ]	**Total**	**Richard**	**Charlotte**	**William**
	£	**£**	**£**	**£**
First PSR period				
[ ] to =				
Interest ([ ])				
PSR ([ ])				
Second PSR period				
[ ] to =				
PSR ([ ])				
Totals				

Basis periods for 2020/21

Richard

[ ] basis

y/e 30.9.20 £ [ ]

Charlotte

[ ] basis

y/e [ ] £ [ ]

William

Last tax year ([ ])

End of previous basis period to cessation

Basis period [ ] to [ ] 20

	£
Partnership allocation	
Less overlap profits	
Taxable trading income	

See **Answer** at the end of this chapter.

Professional skills focus: Assimilating and using information

If a question involves a partnership, it's vital you take the time to note the profit-sharing arrangements as you read the information. If there's a new or retiring partner or the profit-sharing arrangements change make careful note of the date this happens as you'll need to time apportion the profits to apply the rules.

Professional skills focus: Structuring problems and solutions

When you set out your allocation of profits between the partners make sure you clearly present your calculations in a table. If there's a change during the period, ensure you clearly separate out the periods before and after the change and clearly label the dates on either side to help the marker follow your calculations.

2.6 Notional profits and losses

Sometimes, if the partnership makes an overall profit, the allocation of profits results in one or more of the partners making a notional loss. In this case, the profit allocation must be adjusted.

A partner with a notional loss will have a nil amount of taxable trading income.

The total profit will then be reallocated to the remaining partners in proportion to the profit initially allocated to them.

Worked example: Notional loss

Graham, Henry and Isobel are in partnership. In the year to 31 December 2020, the partnership had taxable trading income of £44,500.

During the period, Graham was entitled to a salary of £28,000 and Henry a salary of £24,000. The remaining profits/losses are to be divided equally between the partners.

Requirement

Show the taxable trading income for each of the partners.

Solution

First, allocate the profit in accordance with the partnership sharing arrangements.

	Total	Graham	Henry	Isobel
	£	£	£	£
Salaries	52,000	28,000	24,000	NIL
PSR (1:1:1)	(7,500)	(2,500)	(2,500)	(2,500)
Total	44,500	25,500	21,500	(2,500)

Isobel has a notional loss and therefore will have NIL taxable trading income.

The remaining partners will have the profit of £44,500 reallocated to them:

$$\text{Graham}\ \frac{25{,}500}{25{,}500 + 21{,}500} \times £44{,}500 \qquad £24{,}144$$

$$\text{Henry}\ \frac{21{,}500}{25{,}500 + 21{,}500} \times £444{,}500 \qquad £20{,}356$$

The taxable trading income for each of the partners is therefore:

	Total	Graham	Henry	Isobel
	£	£	£	£
	44,500	24,144	20,356	NIL

A similar situation can arise where the partnership has an overall loss. In this case, the allocation of profits may result in one or more of the partners making a notional profit. The loss allocation must be adjusted.

A partner with a notional profit will have a NIL trading loss.

The total loss will then be reallocated to the remaining partners in proportion to the losses initially allocated to them.

Interactive question 2: Notional profit

Jacqui, Kalid and Leslie are in partnership. In the year to 31 July 2020, the partnership had a trading loss of £(24,000).

During the period, Jacqui was entitled to a salary of £66,000. The partners share profits and losses (after Jacqui's salary) 25% to Jacqui, 25% to Kalid and 50% to Leslie.

Requirement

Using the standard format below, show the trading loss for each of the partners.

First, allocate the loss in accordance with the partnership sharing arrangements.

	Total	Jacqui	Kalid	Leslie
	£	£	£	£
Salary	66,000	66,000	NIL	NIL
PSR (25:25:50)	(90,000)	(22,500)	(22,500)	(45,000)
Total	(24,000)	43,500	(22,500)	(45,000)

Jacqui has a notional profit and therefore will have no trading loss.

The remaining partners will have the loss of £24,000 reallocated to them:

Kalid

$$\frac{22{,}500}{22{,}500 + 45{,}000} \times £(24{,}000) = £8000$$

Leslie

$$\frac{45{,}000}{22{,}500 + 45{,}000} \times £(24{,}000) = £16{,}000$$

The trading loss for each of the partners is therefore:

	Total	Jacqui	Kalid	Leslie
	£	£	£	£
	(24,000)	NIL	(8,000)	(16,000)

See **Answer** at the end of this chapter.

2.7 Loss relief for partners

Partners are entitled to the same loss reliefs as a sole trader.

Each partner makes his own loss relief claim based on his own circumstances. For example, a partner joining a partnership may claim s.72 loss relief for losses in the first four tax years that he is a member of the partnership.

Similarly, a partner leaving a partnership is entitled to closing years loss relief under s.89.

Continuing partners may use loss relief under s.83 and s.64.

As for non-active traders (see earlier in this manual), if a partner does not devote a 'significant' amount of time to the trade, the loss relief available against total income or capital gains is restricted to a maximum of £25,000. It is also restricted by reference to the non-active partner's capital contribution for losses sustained in the first four tax years of trading.

Similar to sole traders, if the loss arises as a result of tax avoidance, loss relief at any time will be restricted.

2.8 Capital gains

Partnership capital transactions are treated as dealings by the individual partners rather than the partnership. Each partner is treated as owning a fractional share of each of the partnership assets.

Each partner is chargeable on his share of gains arising on disposals of partnership assets. The chargeable gain on the disposal of an asset will be allocated to the partners in accordance with the partnership capital profit sharing ratio.

3 Limited liability partnerships

Section overview

- The liability of partners in a limited liability partnership (LLP) is limited to their capital contributions.
- Partners in a LLP are taxed on a similar basis to unlimited liability partners.
- Certain partners (salaried members) of an LLP are treated as employees for tax purposes if the payments they receive from the LLP do not vary with the profits of the LLP.
- Loss relief under s.64 and s.72 is restricted to a partner's capital contribution.

4.1 What is a limited liability partnership?

Most partnerships are formed so that the partners each have unlimited liability for the debts of the partnership.

However, it is possible to form a limited liability partnership (LLP) under which the liability of the partners is limited to the amount of capital that they contribute to the partnership.

4.2 Income tax on limited liability partnerships

The partners of an LLP are taxed on a similar basis to those in an unlimited partnership.

Thus, each of the partners is liable to tax on his share of the taxable trading income of the LLP.

4.3 Salaried members of LLP

Although partners (members) of an LLP are taxed like those of an unlimited partnership, there is an exception to this in the case of 'salaried members' of an LLP. Broadly, for these purposes, 'salaried members' are partners who receive payment from the LLP in return for their services, and the payment received is fixed (or if variable, the payment does not vary with the profits of the LLP). Such partners are treated for income tax, national insurance and corporation tax purposes as if they are employees, and not partners.

In an exam question, you will be told if a partner should be treated as a salaried member. Otherwise, apply the usual tax treatment for partners, as explained in this chapter.

4.4 Restriction on loss relief in a limited liability partnership

In general, the partners of an LLP are entitled to loss relief in the same way as partners in an unlimited liability partnership.

However, there is a restriction on the amount of loss that a LLP partner may claim under s.64 and s.72 against income other than that from the partnership. In this case, the loss relief cannot exceed the amount of capital that the partner has contributed to the partnership.

Worked example: LLP loss relief restriction

Martin and Naomi formed a LLP on 6 April 2020. Each contributed capital of £20,000 to the partnership. Profits and losses were to be shared 60:40.

In the year to 5 April 2021, the partnership made a loss of £(40,000).

Requirement

Explain the loss relief available to Martin and Naomi.

Solution

Martin

Loss allocated 60% × £(40,000)	£(24,000)
Capital contributed	£20,000

S.64 or s.72 loss relief will be restricted to (£20,000) since it will all be set against non-partnership income.

The remaining £(4,000) of the loss will be available for relief against future taxable trading income of the partnership under s.83.

Naomi

Loss allocated 40% × £(40,000)	£(16,000)
Capital contributed	£20,000

S.64 or s.72 loss relief will be available on the full £(16,000) of the loss since this is less than the capital contributed. Of course, s.83 relief could be used in addition or instead.

Summary

!! Error resolving referred content !!

Further question practice

1 Knowledge diagnostic

Before you move on to question practice, complete the following knowledge diagnostic and check you are able to confirm you possess the following essential learning from this chapter. It not, you are advised to revisit the relevant learning from the topic indicated.

Confirm your learning	
1.	Can you prepare a profit allocation between partners? (Topic 1)
2.	Do you know how to handle a change in the profit share, a new partner joining or a partner leaving the partnership? (Topic 1)

2 Question practice

Aim to complete all self-test questions at the end of this chapter. The following self-test questions are particularly helpful to further topic understanding and guide skills application before you proceed to the next chapter.

Question	Learning benefit from attempting this question
Q3 Simon, Ted and Angie	This OT question will quickly check that you can deal with a new partner joining a partnership.
Q6 Robin, Sylvia and Taylor	This 10-mark question gets you to allocate partnership profits where we have a joining and leaving partner and then gets you to apply the basis period rules for each partner. It shows you how a partnership question is a great way for you to be tested on all your usual sole trade topics (here the basis period rules) whilst also testing you know how to allocate profits between partners.

Once you have completed these self-test questions, it is beneficial to attempt the following questions from the Question Bank for this module. These questions have been selected to introduce exam style scenarios that will help you improve your knowledge application and professional skills development before you start the next chapter.

Question	Learning benefit from attempting this question
Kim Lien and Mai 1(b)	This short requirement asks you to allocate the trading profit of the partnership between Kim, Lien and Mai. You should have already calculated the tax-adjusted profit in part (a) earlier in your work- you should check the answer to part (a) to remind yourself of the adjusted profit to feed into this part of the question.
Indira part 1 (a) - (c)	This part of the question gets you to adjust the profits of a partnership, calculate capital allowances, appropriate the profit between partners and apply basis period rules.

Refer back to the learning in this chapter for any questions which you did not answer correctly or where the suggested solution has not provided sufficient explanation to answer all your queries.

Once you have attempted these questions, you can continue your studies by moving on to the next chapter.

Technical references

1 Legislation

Reference relates to Income Tax (Trading and Other Income) Act 2005 (*ITTOIA 2005*)

- Partnerships
  - **ss.846 – 856**

Reference relates to Income Tax Act 2007 (*ITA 2007*)

- Restriction on loss in LLP
  - **s.107**

2 HMRC manual references: Business Income manual

(Found at https://www.gov.uk/hmrc-internal-manuals/business-income-manual)

- Partnerships: General notes
  - **BIM82000**
- Partnerships: General notes – Sharing Profits/Losses
  - **BIM82055**

Self-test questions

Answer the following questions.

- Which **two** of the following statements about partnerships are true?

  A The taxable trading income of the partnership is allocated to individual partners according to the profit-sharing ratio of the period of account

  B The taxable trading income of the partnership is allocated to individual partners according to the profit-sharing ratio of the tax year in which the period of account ends

  C Each partner is liable for the income tax liability of the partnership as a whole

  D Each partner is only responsible for the income tax liability on his share of the partnership taxable trading income

- Arnold, Betty and Christie have been in partnership for many years. Partnership accounts have been made up to 30 April each year. Profits have been shared 20% to Arnold and Betty and 60% to Christie.

  Christie left the partnership on 30 April 2020. The taxable trading income for the partnership is as follows:

  y/e 30.4.19: £70,000

  y/e 30.4.20: £150,000

  Christie had overlap profits on commencement of £12,000.

  What is Christie's taxable trading income for 2020/21?

  A £70,000

  B £30,000

  C £78,000

  D £90,000

- Simon, Ted and Angie are in partnership. They prepare accounts to 30 November each year and share profits equally.

  On 1 December 2020, Mike joins the partnership. From this date, the profit-sharing agreement changes so that Mike receives a salary of £4,000 a year and the balance of the profits are shared equally.

  The taxable trading income of the partnership is

  y/e 30.11.20: £15,000

  y/e 30.11.21: £28,000

  What is the taxable trading income for Mike for 2020/21 and 2021/22?

  A 2020/21 £4,000, 2021/22 £6,000

  B 2020/21£3,333, 2021/22 £10,000

  C 2020/21 £nil, 2021/22 £10,000

  D 2020/21 £3,333, 2021/22 £11,000

- Jean, Katie and Laura are in partnership. Jean is entitled to a salary of £6,000 and Katie is entitled to a salary of £3,000. Remaining profits are shared equally.

  In the year to 31 December 2020, the partnership made a profit of £6,000.

  What is Jean's taxable trading income for the period?

  A NIL

  B £1,714

  C £4,286

  D £5,000

. Peter is a member of a limited liability partnership in which he contributed £6,000 capital. He is entitled to a 1/10th share of profits/losses.

In the y/e 31 March 2021, the partnership made a loss of £(100,000) for the first time. Peter had savings income of £8,000 in 2020/21.

Peter makes a claim under s.64 to set the maximum possible loss against his income in 2020/21.

What is the amount of loss available to carry forward under s.83?

NIL

B £2,000

C £4,000

D £10,000

1 Robin, Sylvia and Taylor

Robin, Sylvia and Taylor traded in partnership for many years.

The profit-sharing arrangements were:

	Robin	Sylvia	Taylor
Salaries	£7,500	£6,000	£5,000
Remaining profits	2	2	1

On 30 June 2021, Taylor left the partnership. He had no overlap profits. On 1 July 2021, Una joined the partnership.

From 1 July 2021, the profit-sharing arrangements were:

	Robin	Sylvia	Una
Salaries	£9,000	£9,000	£9,000
Remaining profits	6	3	1

The partnership makes up accounts to 31 December each year and had the following taxable trading income:

	£
y/e 31 December 2020	51,000
y/e 31 December 2021	90,000
y/e 31 December 2022	120,000

Requirement

Show the taxable trading income for each of the partners for the tax years 2020/21, 2021/22 and 2022/23.

Total: 10 marks

Now go back to the Introduction and ensure that you have achieved the Learning outcomes listed for this chapter.

Answers to Interactive questions

Answer to Interactive question 1

First allocate the taxable trading income between the partners:

y/e 30.9.20	Total	Richard	Charlotte	William
	£	£	£	£
First PSR period				
1.10.19 to 30.4.20 = £120,000 × 7/12 ie: £70,000				
Interest (7/12)	10,500	3,500	3,500	3,500
PSR (5:3:2)	59,500	29,750	17,850	11,900
Second PSR period				
1.5.20 to 30.9.20 = £50,000				
PSR (1:1)	50,000	25,000	25,000	n/a
Totals	120,000	58,250	46,350	15,400

Basis periods for 2020/21

Richard

Current year basis

y/e 30.9.20 £58,250

Charlotte

Current year basis

y/e 30.9.20 £46,350

William

Last tax year (2020/21)

End of previous basis period to cessation

Basis period 1.10.19 to 30.4.20

	£
Partnership allocation	15,400
Less overlap profits	(5,000)
Taxable trading income	10,400

Answer to Interactive question 2

First, allocate the loss in accordance with the partnership sharing arrangements.

	Total	Jacqui	Kalid	Leslie
	£	£	£	£
Salary	66,000	66,000	NIL	NIL
PSR (25:25:50)	(90,000)	(22,500)	(22,500)	(45,000)
Total	(24,000)	43,500	(22,500)	(45,000)

Jacqui has a notional profit and therefore will have no trading loss.

The remaining partners will have the loss of £24,000 reallocated to them:

Kalid

$$\frac{22,500}{22,500 + 45,000} \times £(24,000) = £8000$$

Leslie

$$\frac{45,000}{22,500 + 45,000} \times £(24,000) = £16,000$$

The trading loss for each of the partners is therefore:

Total	**Jacqui**	**Kalid**	**Leslie**
£	**£**	**£**	**£**
(24,000)	NIL	(8,000)	(16,000)

Answers to Self-test questions

1 Correct answer(s):

A The taxable trading income of the partnership is allocated to individual partners according to the profit-sharing ratio of the period of account

D Each partner is only responsible for the income tax liability on his share of the partnership taxable trading income

2 Correct answer(s):

C £78,000

Christie

Last tax year

End of previous basis period to cessation

Basis period 1.5.19 to 30.4.20

	£
PSR (60% x £150,000)	90,000
Less overlap profits	(12,000)
Taxable trading income	78,000

3 Correct answer(s):

B 2020/21£3,333, 2021/22 £10,000

B 2020/21£3,333, 2021/22 £10,000

y/e 30.11.21	**Total**	**Mike**
	£	**£**
Salary	4,000	4,000
Balance (25% to Mike)	24,000	6,000
Totals	28,000	10,000

Mike

First tax year (2020/21)

Actual basis

Basis period 1.12.20 to 5.4.21

4/12 × £10,000 = £3,333

Second tax year (2021/22)

12-month period of account ending in 2nd tax year

Basis period 1.12.20 to 30.11.21

y/e 30.11.21 = £10,000

4 Correct answer(s):

C £4,286

This is a notional loss situation.

First, allocate the profit in accordance with the partnership sharing arrangements.

	Total	Jean	Katie	Laura
	£	£	£	£
Salaries	9,000	6,000	3,000	NIL
PSR (1:1:1)	(3,000)	(1,000)	(1,000)	(1,000)
Total	6,000	5,000	2,000	(1,000)

Reallocation:

Jean

$$\frac{5{,}000}{5{,}000 + 2{,}000} \times £6{,}000$$

5 Correct answer(s):

C £4,000

Loss allocated 10% × £(100,000) = £(10,000)

Capital contributed £6,000

S.64 loss relief in 2020/21 will be restricted to £6,000 since it will all be set against non-partnership income.

The remaining £4,000 of the loss will be available for relief against future taxable trading income of the partnership under s.83.

6 Robin, Sylvia and Taylor

First, allocate the profit in accordance with the partnership sharing arrangements for each period of account.

y/e 31.12.20	Robin	Sylvia	Taylor	Una	Total
	£	£	£	£	£
Salaries	7,500	6,000	5,000	NIL	18,500
PSR (2:2:1)	13,000	13,000	6,500	NIL	32,500
Totals	20,500	19,000	11,500	NIL	51,000
y/e 31.12.21					
1.1.21 – 30.6.21 = £45,000					
Salaries	3,750	3,000	2,500	NIL	9,250
PSR (2:2:1)	14,300	14,300	7,150	NIL	35,750
1.7.21 – 31.12.21 = £45,000					
Salaries	4,500	4,500	NIL	4,500	13,500
PSR (6:3:1)	18,900	9,450	NIL	3,150	31,500
	41,450	31,250	9,650	7,650	90,000
y/e 31.12.22					
Salaries	9,000	9,000	NIL	9,000	27,000
PSR (6:3:1)	55,800	27,900	NIL	9,300	93,000
	64,800	36,900	NIL	18,300	120,000

Now allocate to each tax year:

Robin

2020/21	y/e 31.12.20	£20,500
2021/22	y/e 31.12.21	£41,450
2022/23	y/e 31.12.22	£64,800

Sylvia

2020/21	y/e 31.12.20	£19,000
2021/22	y/e 31.12.21	£31,250
2022/23	y/e 31.12.22	£36,900

Taylor

2020/21	y/e 31.12.20	£11,500
2021/22	p/e 30.06.21 (last year)	£9,650

Una

2021/22	First tax year	
	Actual basis	
	Basis period 1.7.21 to 5.4.22	**£**
	1.7.21 – 31.12.21	7,650
	1.1.22 – 5.4.22 3/12 × £18,300	4,575
		12,225
2022/23	Second tax year	
	y/e 31.12.22	£18,300

Chapter 2

Evidence and sampling

Introduction

Learning outcomes

Gathering evidence on an assurance engagement

Students will be able to select sufficient and appropriate methods of obtaining assurance evidence and recognise when conclusions can be drawn from evidence obtained or where issues need to be referred to a senior colleague.

In the assessment, students may be required to:

- identify the different methods of obtaining evidence from the use of tests of control, substantive procedures, including analytical procedures and data analytics
- recognise the strengths and weaknesses of the different methods of obtaining evidence
- identify the situations within which the different methods of obtaining evidence should and should not be used
- compare the reliability of different types of assurance evidence
- recognise when the quantity (including factors affecting sample design) and quality of evidence gathered is of a sufficient and appropriate level, after taking account of sampling risk, to draw conclusions on which to base a report

Specific syllabus references for this chapter: 3b, c, d, e, g

Syllabus links

In Audit and Assurance you will focus on the drawing conclusions part of evidence, based on the collection of evidence that we focus on in this Assurance manual.

Examination context

This is a very important part of your syllabus and the issues discussed here and previously in Chapter 4 underpin the following two chapters as well. You can expect a number of practical and theoretical questions in the assessment covering audit evidence.

Chapter study guidance

Use this schedule and your study timetable to plan the dates on which you will complete your study of Chapter 11 Evidence and sampling.

Topic	Practical significance	Study approach	Exam approach	Self-test questions
1	**Evidence** Evidence is what the assurance conclusion is based on. Therefore, in practice, knowing which tests to carry out and how many items to test is an important practical skill. Getting it wrong may cost the firm money, if too	**Section 1.1** of this chapter picks up on some of the points on evidence introduced in Chapter 4. Review these points briefly as they should be familiar. Then read through **sections 1.2 – 1.6.** Notice in particular the different	This is a very important part of your syllabus and the issues discussed here and previously in Chapter 4 underpin the following two chapters as well. You can expect a number of practical and theoretical questions in the assessment	3

Topic	Practical significance	Study approach	Exam approach	Self-test questions
	much work is done, or leave the firm exposed to negligence claims, if insufficient work is done. It is an area where considerable judgement will have to be exercised. **Stop and think** How do you think an auditor determines how much evidence to obtain?	procedures which can be used to obtain evidence and the way in which CAATs may be used. **Section 1.4** considers analytical procedures as a substantive procedure. You will have come across analytical procedures in Chapter 3 as a planning procedure. Attempt Interactive question 1 before moving on.	covering audit evidence.	
2	**Selecting items to test** If you are training in practice, you are likely to be involved in obtaining evidence, but less likely to be involved in the more judgemental areas of how to obtain it and how much of it to obtain.	**Section 2** looks at the issue of sampling. This is quite a technical topic so read through it slowly ensuring that you understand the various definitions as you work through. Also note the different ways of selecting the sample in **section 2.3** and review the worked example.	This is an important and examinable section. It covers a lot of material so you will need to work hard to be ready for questions in this area.	1, 2, 5
3	**Drawing conclusions from sampling** As you progress with your training, you will be given opportunity to make judgements in this area. You will be expected to draw conclusions from the audit	Continue to work through this material on sampling, including the worked example, and attempt the interactive question.	This is another important section that you are likely to be tested on.	4

Topic	Practical significance	Study approach	Exam approach	Self-test questions
	work you have undertaken from an early stage. It is important therefore to understand why you are carrying out a particular procedure and what you intend to achieve by it.			
4	**Evaluation of misstatements** It is not uncommon for the auditor to encounter misstatements when conducting audit procedures. It is important that you know how to handle them. **Stop and think** What would you do if you encountered a misstatement when performing an audit procedure?	Work through this section and attempt the interactive question at the end.	This section may come up in your exam, but it is slightly harder to test than some of the other material. It is only a short section, however, so it should not be too onerous for you to retain the information here.	

Once you have worked through this guidance, you will be ready to attempt the further question practice included at the end of this chapter.

1 Evidence

Section overview

- Evidence must be sufficient and appropriate.
- Evidence is obtained in the form of substantive procedures and/or tests of controls.
- Evidence can be obtained by inspection, observation, inquiry and confirmation, recalculation, reperformance and analytical procedures.
- Substantive procedures will test for evidence of understatement or overstatement of account balances.

2.1 Overview of evidence from Chapter 4

You studied the basic principles of evidence in Chapter 4. These are the key points:

Evidence includes all the information contained within the accounting records underlying the financial statements, and other information gathered by the assurance providers, such as confirmations from third parties. Evidence is obtained in relation to the financial statement assertions which were set out in Chapter 4. There are two types of audit procedures; tests of controls (which we have looked at in detail in Chapters 5 to 9) and substantive procedures (which we will look at in more detail in Chapters 12 and 13).

ISA *500* states that evidence must be sufficient and appropriate.

- **Sufficiency** is the measure of the **quantity** of audit evidence.
- **Appropriateness** is the measure of the **quality** or relevance and **reliability** of the audit evidence.

We will look at the quantity of evidence obtained in section 2 below.

There are some general principles relating to the quality of evidence which were set out in Chapter 4.

Quality of evidence	
External	Evidence from **external sources** is more reliable than that obtained from the entity's records
Auditor	Evidence obtained **directly by assurance providers** is more reliable than that obtained indirectly or by inference
Entity	Evidence obtained from the entity's records is more reliable when related **control systems operate effectively**
Written	Evidence in the form of **documents (paper or electronic)** or **written representations** are more reliable than oral representations
Originals	Original documents are more reliable than photocopies, or facsimiles

2.2 Procedures to obtain evidence

Assurance providers obtain evidence by one or more of the following procedures outlined in ISA 500.

Procedures	Explanation	Strengths and weaknesses
Inspection of tangible assets	Inspection (physical examination) of tangible assets that are recorded in the accounting records confirms existence, but does not confirm rights and obligations or	Inspection of assets is a good procedure, particularly in the case of assets that the entity could not function without (for

Procedures	Explanation	Strengths and weaknesses
	valuation. For example, machinery recorded in asset register can be inspected by assurance providers. Confirmation that assets seen are recorded in accounting records gives evidence of completeness. However, this is limited to assets assurance providers can see – if assets have been taken off site (hidden) they might not be picked up.	example its production plant), but the weakness associated with inspection is that assets not used in daily production could be hidden from the assurance providers and not included in financial statements.
Inspection of documentation	Inspection of documents involves examining records or documents, for example, looking at a sales contract or a share certificate. What inspection of documents achieves depends on the nature of the document. For example, looking at a share certificate gives evidence of the existence of the investment. Looking at source documents (eg, sales invoices) and tracing to financial statements gives evidence of completeness (eg, of revenue). Inspection also provides evidence of valuation (for example, a purchase invoice gives evidence of the cost of inventory), rights and obligations (for example, a hire purchase agreement gives evidence in relation to ownership of non-current assets) and the nature of items (presentation and disclosure). It can also be used to compare documents (and hence test consistency of audit evidence) and confirm authorisation.	The strength of this procedure depends on what is being inspected to give evidence. For instance, inspection of a purchase invoice gives better quality evidence than inspection of sales invoice, because a purchase invoice is created by a third party.
Observation	This involves watching a procedure being performed (for example, post opening).	This procedure is relatively weak, as it only confirms that the procedure is being performed correctly when the assurance provider is watching.
Inquiry	This involves seeking information from client management or staff or external sources and evaluating responses.	The strength or weakness of this procedure will depend on of whom the inquiry is being made – a member of client staff could misrepresent matters to the assurance provider if they misunderstand the nature of the question, or they are seeking to conceal a misstatement or fraud.
External confirmation (a particular form of inquiry)	This involves seeking confirmation from a third party eg, confirmation from bank of bank balances.	This can be a very strong procedure but there may be instances where the third party is motivated to misrepresent, for example an understated receivables balance might be confirmed because it favoured the customer.

Procedures	Explanation	Strengths and weaknesses
Recalculation	Checking mathematical accuracy of client's records, for example, adding up ledger accounts.	Recalculation is evidence created by the assurance provider so is strong evidence.
Reperformance	Independently executing procedures or controls, either manually or through the use of computer assisted audit techniques (covered below).	Again, the fact that the assurance provider carries out the performance of a control himself makes it strong evidence.
Analytical procedures	Evaluating and comparing financial and/or non-financial data for plausible relationships and investigating unexpected fluctuations.	Evidence here is limited by the strength or weakness of the underlying accounting system. However, this can be a strong procedure if comparison is made to items that do not rely on the same accounting system or that the assurance provider can corroborate outside the accounting system.

Often these procedures will be used in conjunction with one another to provide a greater quality of evidence. For example, an assurance provider might observe controls in operation and then reperform the control himself to confirm that it operates as he has observed. Auditors will gather detailed evidence but other assurance providers may need less evidence.

2.3 Computer assisted audit techniques

With so many accounting systems now held on computer, the assurance provider may wish to make use of computer assisted audit techniques (CAATs). These have been mentioned before in your Study Manual, particularly in Chapter 5. There are three main types of CAAT that can be used:

- test data
- audit software
- data analytics

2.3.1 Test data

Under this test of control, the assurance provider supervises the process of running data through the client's system. The stages in the use of test data are as follows:

- Note controls in client's system
- Decide upon test data, the options include:
  - dummy data (the assurance provider must be very careful to reverse all effects)
  - real data (the data may not contain all the errors necessary to test the controls rigorously)
  - dummy data against a verified copy of the client's system (much safer)
- Run the test data
- Compare results with those expected
- Conclude on whether controls are operating properly

Context example: Context example: Test data

Test data makes use of the client's own system. To carry out such a test the assurance provider identifies a control (or series of controls) in the client's system. The assurance provider then predicts the system's reaction to the test data. For example:

- an invoice which does not cast should be rejected when entered in the system.

- an invoice with an invalid supplier code should be rejected.
- dates outside the current year should be rejected.
- valid data should be posted to the correct account.

The assurance provider then runs the test data through the client's system (or a copy thereof) and compares the results with those expected. The results tell the assurance provider whether the controls within the system are operating correctly; the test is therefore a test of control

2.3.2 Audit software

Audit software makes use of the assurance providers' own specialised software. There are a number of off-the-shelf packages available, or the assurance provider could have a tailor-made system. Audit software works on the basis of interrogating the client's system and extracting and analysing information. It can therefore carry out a whole range of substantive procedures, across all sorts of different data.

Examples of what audit software can do include the following:

- Extract a sample according to specified criteria:
  - Random
  - Over a certain amount
  - Below a certain amount
  - At certain dates
- Calculate ratios and select those outside set criteria (eg, more than 5% different from last year)
- Check calculations and casts performed by the system
- Prepare reports (eg, comparison of actual against budgeted figures)
- Follow items through a system and flag where they are posted

The procedures listed above are mostly substantive procedures, because they are substantiating the figures in the accounts. To generate more procedures that can be done using audit software, just think of the substantive procedures that you may wish to carry out, and consider whether the information is held on the client's computer (you can normally assume that it is). If the test does not require judgement, then it can almost certainly be carried out by audit software.

2.3.3 Data analytics

Definition

Data analytics: When used to obtain audit evidence in a financial statement audit, data analytics is the science and art of discovering and analysing patterns, deviations and inconsistencies, and extracting other useful information in the data underlying or related to the subject matter of an audit through analysis, modelling and visualisation for the purpose of planning and performing the audit.

FRC, 2017, *Audit Quality Thematic Review*: *The Use of Data Analytics in the Audit of Financial Statements*)

Within an audit context this is sometimes known as Audit Data Analytics, or ADA.

Data analytics is a very hot topic in the auditing profession, and can be seen as part of the broader revolution wrought by 'big data'. Data analytics are fundamentally a modern, developed form of CAATs, and whereas CAATs never really changed the audit profession as a whole, it is possible that data analytics will do.

Auditors have for many years used computers to help them, developing the CAATs and audit software discussed above, but technology has not really been powerful enough to make these tools worth the time that needed to be invested in them. A key problem was the need to tailor the CAATs to each audit client, which could be costly. Many auditors did not use them.

In recent years, however, computing power has developed to the point where much more complex testing can be performed on data, but crucially **without the need to create tailor-made software**. Data analytics software came from the older audit software, but is standardised and more powerful.

Now, standard data analytics techniques can simply be applied to a client's data, and since this is a much more efficient process than before, it is beginning to be adopted widely within the profession.

Auditors can generate intuitive visualisations of very complex data (eg, bubble, bar or pie charts), which they can then use in their analysis to spot trends that might otherwise have been missed.

Here are some examples of specific areas where ADA may be useful:

- Analyse all transactions in a population, stratify that population and identify outliers for further examination
- Reperform calculations relevant to the financial statements
- Match transactions as they pass through a processing cycle
- Assist in segregation of duties testing
- Compare entity data to externally obtained data
- Manipulate data to assess the impact of different assumptions.
- Analyses of revenue trends split by product or region
- Matches of orders to cash and purchases to payments
- Three-way matches between purchase/sales orders, goods received/despatched documentation and invoices
- 'Can do, did do testing' of user codes to test whether segregation of duties is appropriate, and whether any inappropriate combinations of users have been involved in processing transactions.

(FRC, 2017: p7)

2.4 Analytical procedures

ISA (UK) 520, *Analytical Procedures* gives more detail on the use of analytical procedures as substantive procedures (optional) and at the overall review stage (compulsory) of an audit. The use of analytical procedures in planning (compulsory) is included in ISA 315 and was covered in Chapter 3. These ISAs apply to audits only, but all assurance providers may be able to use analytical procedures (indeed, they will be an important tool where less detailed evidence is required) and will need to consider the same general principles.

ISA 520 describes how the **auditor** must decide whether using substantive analytical procedures will be effective and efficient in **reducing audit risk** to an acceptably low level. Auditors may find it effective to use analytical data prepared by the entity's management, provided they are satisfied that it has been properly prepared.

There are a number of factors that the auditors should consider when using analytical procedures as substantive procedures:

- Objective of the analytical procedures (for example analytical procedures may be good at indicating whether a population is complete)
- Suitability of analytical procedures
- Reliability of the data

Factor	Issues to consider
Suitability 	• (Generally analytical procedures are more applicable to large volumes of transactions that tend to be predictable (for example, payroll). • (It depends on the purpose of the test – for example, some analytical procedures will provide persuasive evidence and others will provide corroboration of other tests. • (Other audit tests directed to the same assertions. • (The auditor must decide if analytical procedures are suitable given the nature of the assertion and the assessment of risk associated with it.
Reliability of the data	• (The source of the information used (third party or internal, for example).

Factor	Issues to consider
	• (The comparability of the information (for example, an industry standard may not be useful if the company is unusual within the industry). • (Nature and relevance of the information used (for example, if comparing something to budget, is the budget realistic or more of a target?). • (Whether there are controls over the production of the information used to ensure completeness, accuracy, validity.
Precision	• (The accuracy with which results in test area can be predicted (for example, compare gross margin with a less predictable item, for example, advertising). • (The extent to which information can be disaggregated (for example, by division). • (Availability of required information.
Acceptable difference	This is influenced by materiality and the desired level of assurance. As assessed risk rises, the amount of difference from expected results considered acceptable without investigation will reduce.

When analytical procedures identify significant fluctuations or relationships that are inconsistent with other relevant information, or that are not the results that were expected, this must be investigated further.

The auditor shall make inquiries of management about the inconsistency or unexpected result and then corroborate those replies with other evidence.

If management responses cannot be corroborated or are unavailable, the auditor shall perform other audit procedures as necessary.

The auditor may consider testing the operating effectiveness of controls, if any, over the **preparation** of **information** used in applying analytical procedures. When such controls are effective, the auditor generally has greater confidence in the reliability of the information, and therefore in the results of analytical procedures.

The operating effectiveness of **controls** over **non-financial information** may often be tested in conjunction with other tests of controls. For example, in establishing controls over the processing of sales invoices, a business may include controls over the recording of sales units. In these circumstances the auditor may test the operating effectiveness of controls over the recording of unit sales in conjunction with tests of the operating effectiveness of controls over the processing of sales invoices.

The suitability of a particular analytical procedure will depend upon the auditor's assessment of how effective it will be in detecting a misstatement that may cause the financial statements to be materially misstated.

The ISA states that 'the auditor shall design and perform analytical procedures near the end of the audit that assist the auditor when forming an overall conclusion as to whether the financial statements are consistent with the auditor's understanding of the entity' (ISA (UK) 520: para. 6).

The conclusions from these analytical procedures should corroborate the conclusions formed from other audit procedures on parts of the financial statements. This assists the auditor to draw reasonable conclusions on which to base the audit opinion. However, these analytical procedures may identify a previously unrecognised risk of material misstatement. In such circumstances the auditor is required to revise the auditor's assessment of the risks of material misstatement and modify the further planned audit procedures accordingly.

As we have discussed, analytical procedures should be used at the risk assessment stage. Possible sources of information about the client include:

- interim financial information
- budgets
- management accounts

- non-financial information
- bank and cash records
- sales tax returns
- board minutes
- discussions or correspondence with the client at the year end

Auditors may also use specific industry information or general knowledge of current industry conditions to assess the client's performance.

As well as helping to determine the nature, timing and extent of other audit procedures, such analytical procedures may also indicate aspects of the business of which the auditors were previously unaware. Auditors are looking to see if developments in the client's business have had the expected effects. They will be particularly interested in changes in audit areas where problems have occurred in the past.

2.5 Directional testing

For any item in the final statements which is being tested there are two possibilities. It could be fairly stated or misstated.

If it is misstated there are again two possibilities. It could be:

- overstated; or
- understated.

When testing for overstatement (or existence/occurrence) a different approach is used from testing for understatement (or completeness).

Context example: Context example: Two invoices

Imagine two invoices, each for £1,000.

Invoice 1 is a fraudulent invoice for the purchase of a non-current asset and should not have been posted. As a result, non-current assets are overstated by £1,000 (before depreciation). To find this misstatement the auditor can either:

- look at all the purchase invoices and try to identify the fraudulent one; or
- look at the figure for non-current assets in the financial statements and gradually follow the audit trail until arriving at persuasive supporting evidence.

One might think that either of these approaches would work. If the fraudulent invoice had been suppressed in some way, however, it would be impossible to find it by looking through the invoices. It follows therefore that, when testing for overstatement, the auditor should start with the figures given, and follow the audit trail until coming to the supporting documentation.

To summarise, the pattern for overstatement testing is as follows:

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Now consider invoice 2, a sales invoice which has been omitted resulting in an understatement of revenue by £1,000. In this case, selecting a sample from the final revenue figure in the financial statements will be no use. As the item has been omitted, it will be impossible to select it and test it.

So in order to test for understatement the auditor will have to select from a population which will give the chance of selecting omitted items. Such a population has been described as 'a reciprocal population'. For invoice 2, that population would be the entity's dispatch notes, provided that the auditor is satisfied that all despatches are 'captured' on dispatch notes at the point of dispatch.

A reciprocal population for **accounts payable** is more difficult to arrive at. Paragraph A27 of ISA 500 suggests that when testing accounts payable for understatement, such a population could be:

- subsequent disbursements
- unpaid invoices

- suppliers' statements
- unmatched receiving reports

The pattern for understatement (or completeness) testing can be summarised as follows.

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Traditionally directional testing has been used as a mechanism for reducing the amount of testing done. If in a double entry bookkeeping system there is a debit for every credit, the trial balance balances and all debit entries (expenses and assets) are tested for overstatement, and all credit entries (revenue, liabilities, equity and reserves) are tested for understatement, it is possible to draw the conclusion that, if no misstatements are found, all items are fairly stated.

The 'normal' approach adopted, therefore, is to test debits for overstatement and credits for understatement.

However, note that the majority of high profile corporate scandals (including Enron) have involved the overstatement of income rather than its understatement. Money laundering schemes would also tend to show similar characteristics. It is important therefore to assess the true risks, rather than automatically apply a formula.

Interactive question 1: Evidence

In respect of an assurance engagement, which one of the following is the least persuasive method of gathering evidence?

A Inspection of a purchase invoice

B Inspection of a sales invoice

C Inspection of inventory by the auditor

D Reperformance of a supplier statement reconciliation undertaken by the client

See **Answer** at the end of this chapter.

2.6 Audit of accounting estimates

The auditor often has to audit estimated figures, such as those for product warranties, depreciation, inventory or receivables allowances, where the values included in the financial statements are not the result of transactions with third parties (which are fairly reliable) but result from judgements made by management. Yet these figures can have a very significant effect on reported profits.

There is a risk that management may be biased in the judgements it makes when calculating estimated figures. The auditor must therefore approach these values with professional scepticism regarding the judgements made.

The audit approach required is set out in ISA (UK) 540 (Revised), *Auditing Accounting Estimates and Related Disclosures*. Essentially, if risk assessment procedures have identified a risk of material misstatement due to accounting estimates, the auditor can respond by undertaking one or more of the following methods.

Method	Example
Test the process that management used to estimate the figure and the data on which it is based	Management may use a formula to calculate the allowance for receivables. The auditor can test this by: • (checking the calculation • (considering if anything this year is likely to have changed the estimate
Use a point estimate	The auditors may use an available or proprietary model, or introduce different assumptions, or engage a specialist to develop a model.

Method	Example
Review events occurring up to the date of the auditor's report	If a settlement is reached after the year end regarding a claim against the company which requires a provision, the auditor can use the evidence of the agreement to establish the correct figure for the financial statements. In this case there is usually no need to use the other two methods.
Test the operating effectiveness of controls over how management made the accounting estimate, with associated substantive procedures	If there are strong controls over the estimation, and the estimate is derived from the routine processing of data by the entity's accounting system.

Having done the detailed work on the accounting estimate, the auditor checks the reasonableness of the figure and then reaches a conclusion about whether it is fairly stated.

This sort of work is clearly needed in an audit assignment, where estimates such as provisions required for damages in a lawsuit might be required, but the work is also very relevant to a number of other types of assurance engagement. Reports on a business plan often require an accounting estimate to be checked. The techniques used in these assignments will be the same as for audit assignments.

3 Selecting items to test

Section overview

- Assurance providers usually seek evidence from less than 100% of items of the balance or transaction being tested.
- Every item in the population of items being sampled must have an equal chance of being selected in the sample.
- The greater the risk of the area being sampled, the higher the sample size will be.
- When drawing conclusions from sampling, the auditor must identify which discovered misstatements affect the overall balance.

4.1 The concept of sampling

Assurance providers do not normally examine all the information available to them; it would be impractical to do so and using sampling will produce valid conclusions provided it is carried out properly.

ISA (UK) 530, *Audit Sampling* states that 'the objective of the auditor, when using audit sampling, is to provide a reasonable basis for the auditor to draw conclusions about the population from which the sample is selected'. Remember that the ISA relates specifically to audits, but all assurance providers may use sampling.

(*ISA (UK) 530: para. 4*)

Definitions

Audit sampling: The application of audit procedures to **less than 100% of items** within a population of audit relevance such that all sampling units have a chance of selection in order to provide the auditor with a reasonable basis on which to draw conclusions about the entire population.

Population: The entire set of data from which a sample is selected and about which an auditor wishes to draw conclusions.

Some testing procedures do **not** involve sampling, such as:

- **testing all** items in a population (100% examination)
- testing all items with a **certain characteristic**, as selection is not representative

Assurance providers are unlikely to test 100% of items when carrying out tests of control, but 100% examination may be appropriate for certain substantive procedures. For example, if the population is made up of a small number of high value items and there is a high risk of material misstatement then 100% examination may be appropriate.

The ISA requires distinguishes between **statistical sampling** and **non-statistical methods**.

Definitions

Statistical sampling: An approach to sampling that has the following characteristics:

(a) Random selection of the sample items; and

(b) The use of probability theory to evaluate sample results, including measurement of sampling risk.

Non-statistical sampling: A sampling approach that does not have characteristics (a) and (b) is considered non-statistical sampling.

The auditor may alternatively select certain items from a population because of specific characteristics they possess. The results of items selected in this way cannot be projected onto the whole population but may be used in conjunction with other audit evidence concerning the rest of the population.

- **High value or key items.** The auditor may select high value items or items that are suspicious, unusual or prone to error.
- **All items over a certain amount**. Selecting items this way may mean a large proportion of the population can be verified by testing a few items.
- **Items to obtain information** about the client's business, the nature of transactions, or the client's accounting and control systems.

4.2 Design of the sample

When designing the sample, ISA 530 requires the auditor to 'consider the **purpose** of the audit procedure and the **characteristics of the population** from which the sample will be drawn', and to consider the sampling and selection methods.

(*ISA (UK) 530: para. 6*)

When designing an audit sample, the auditor's consideration includes the specific purpose to be achieved and the combination of audit procedures that is likely to best achieve that purpose. The auditor also needs to consider the nature and characteristics of the audit evidence sought and possible deviation or misstatement conditions. This will help them to define **what constitutes a deviation or misstatement** and **what population to use** for sampling.

Definitions

Misstatement: A difference between the amount, classification, presentation, or disclosure of a reported financial statement item and the amount, classification, presentation, or disclosure that is required for the item to be in accordance with the applicable financial reporting framework. Misstatements can arise from error or fraud.

Error: An unintentional misstatement in financial statements, including the omission of an amount or a disclosure.

The population from which the sample is drawn must be **appropriate and complete** for the specific audit objectives. Auditors must **define** the **sampling unit** in order to obtain an efficient and effective sample to achieve the particular audit objectives.

Definition

Sampling units: The individual items constituting a population.

Context example: Context example: Sampling units

- Cheques listed on deposit slips
- Credit entries on bank statements
- Sales invoices
- Receivables balances
- A monetary unit (an example of monetary unit sampling is given in section 2.3)

ISA 530 requires that the auditor 'shall select items for the sample in such a way that each sampling unit in the population has a chance of selection'. This requires that **all items** in the population have an opportunity to be selected.

As we saw above, in obtaining evidence, the auditor should use professional judgement to assess audit risk and design audit procedures to ensure this risk is reduced to an acceptably low level. In determining the sample size, the auditor shall determine a sample size sufficient to reduce sampling risk is reduced to an acceptably low level.

Definitions

Sampling risk: The risk that the auditor's conclusion based on a sample may be different from the conclusion if the entire population were subjected to the same audit procedure.

Non-sampling risk: The risk that the auditor reaches an erroneous conclusion for any reason not related to sampling risk. For example, the use of inappropriate procedures, or misinterpretation of audit evidence and failure to recognise a misstatement or deviation.

4.2.1 Factors influencing sample sizes

ISA 530 gives examples of factors which influence sample sizes for tests of controls and tests of details:

Tests of controls	
Factor	**Effect on sample size**
An increase in the extent to which the auditor's risk assessment takes into account relevant controls	Increase
An increase in the tolerable rate of deviation	Decrease
An increase in the expected rate of deviation of the population to be tested	Increase
An increase in the auditor's desired level of assurance that the tolerable rate of deviation is not exceeded by the actual rate of deviation in the population	Increase
An increase in the number of sampling units in the population	Negligible effect

Tests of details	
Factor	**Effect on sample size**
An increase in the auditor's assessment of the risk of material misstatement	Increase
An increase in the use of other substantive procedures directed at the same assertion	Decrease
An increase in the auditor's desired level of assurance that tolerable misstatement is not exceeded by actual misstatement in the population	Increase
An increase in tolerable misstatement	Decrease
An increase in the amount of misstatement the auditor expects to find in the population	Increase
Stratification of the population when appropriate	Decrease
The number of sampling units in the population	Negligible effect

The greater the auditor's desired level of assurance that the results of the sample are in fact indicative of the actual misstatement in the population, the larger sample sizes have to be. In other words, if the auditor is placing a great deal of relevance on this (it is not corroborating other evidence, for example) the higher the sample size will have to be.

Definition

Tolerable misstatement is a monetary amount set by the auditor in respect of which the auditor seeks to obtain an appropriate level of assurance that the monetary amount set by the auditor is not exceeded by the actual misstatement in the population.

Tolerable rate of deviation is a rate of deviation from prescribed internal control procedures set by the auditor in respect of which the auditor seeks to obtain an appropriate level of assurance that the rate of deviation set by the auditor is not exceeded by the actual rate of deviation in the population.

Tolerable misstatement is considered during the planning stage and, for substantive procedures, is related to the auditor's judgement about materiality. The smaller the tolerable misstatement, the greater the sample size will need to be.

(a) For tests of controls, the auditor makes an assessment of the **expected rate of deviation** based on the auditor's understanding of the relevant controls or on the examination of a small number of items from the population. If the expected rate of deviation is unacceptably high, the auditor will normally decide not to perform tests of controls.

(b) For tests of details, the auditor makes an assessment of the **expected misstatement** in the population, If the expected misstatement is high, 100% examination or use of a large sample size may be appropriate when performing tests of details.

The level of sampling risk that the auditor is willing to accept affects the sample size required. The lower the risk the auditor is willing to accept, the greater the sample size will need to be.

Context example: Context example: Designing the sample

Sarah is planning the audit of receivables at Manufacturing Company Limited (MCL). MCL makes all its sales on credit, and the receivables ledger is extensive. However, Sarah has judged the area to be low risk as most customers pay their debts promptly and controls over the receivables ledger and credit control are good. In previous years, testing has revealed that few misstatements are discovered. She therefore selects a small sample.

During the course of testing, Sarah discovers a much higher number of misstatements than she was expecting. She therefore increases her sample and extends her test.

In practice, most auditing firms use computer programs to set sample sizes, based on risk assessments and materiality.

4.3 Selecting the sample

There are a number of selection methods available.

(a) **Random selection** ensures that all items in the population have an equal chance of selection eg, by use of random number tables or computerised generator.

(b) **Systematic selection** involves selecting items using a constant interval between selections, the first interval having a random start. When using systematic selection assurance providers must ensure that the population is not structured in such a manner that the sampling interval corresponds with a particular pattern in the population.

(c) **Haphazard selection** may be an alternative to random selection provided assurance providers are satisfied that the sample is representative of the entire population. This method requires care to guard against making a selection that is biased, for example towards items that are easily located, as they may not be representative. It should not be used if assurance providers are carrying out statistical sampling.

(d) **Sequence or block selection**. Sequence sampling may be used to check whether certain items have particular characteristics. For example, an auditor may use a sample of 50 consecutive cheques to check whether cheques are signed by authorised signatories rather than picking 50 single cheques throughout the year. Sequence sampling may, however, produce samples that are not representative of the population as a whole, particularly if misstatements only occurred during a certain part of the period, and hence the misstatements found cannot be projected onto the rest of the population.

(e) **Monetary Unit Sampling (MUS)**. This is a selection method that ensures that every £1 in a population has an equal chance of being selected for testing. The advantages of this selection method are that it is easy when computers are used, and that every material item will automatically be sampled. Disadvantages include the fact that if computers are not used, it can be time consuming to pick the sample, and that MUS does not cope well with errors of understatement (as the computer cannot select a £ which is not there) or negative balances.

Different approaches are possible here. The approach taken may depend on a firm's culture as much as anything; other factors would include the particular client being audited and the kind of data that is available to the audit firm.

Context example: Context example: MUS

You are auditing trade accounts receivable and are testing for overstatement. Total trade account receivables is £500,000 and performance materiality is £50,000. You will select the balances containing each 50,000th £1 from the following ledger.

Customer	Balance	Cumulative total	Selected
A	30,000	30,000	
B	35,000	65,000	Yes
C	45,000	110,000	Yes
D	**52,000**	**162,000**	**Yes**

Customer	Balance	Cumulative total	Selected
E	13,000	175,000	
F	**50,000**	**225,000**	**Yes**
G	23,000	248,000	
H	500	248,500	
I	41,500	290,000	Yes
J	47,000	337,000	Yes
K	**54,000**	**391,000**	**Yes**
L	17,000	408,000	Yes
M	**80,000**	**488,000**	**Yes**
N	12,000	500,000	Yes
	500,000		

Material items are shown **in bold** and have all automatically been selected. The cumulative column helps you to determine when the next 50,000th £1 has been reached

Interactive question 2: Factors affecting sample size

When determining a sample size for tests of detail there are a number of factors that an auditor should take into account.

For each of the following factors, select whether it would cause the sample size to increase or decrease.

	Increase/Decrease
Decrease in the assessed level of tolerable misstatement.	
Increase in the assessed risk level.	
Discovery of more misstatements than were anticipated during testing.	

See **Answer** at the end of this chapter.

5 Drawing conclusions from sampling

Section overview

- The purpose of sampling a set of items was to enable the auditors to project the conclusion to the whole population.
- Auditors must consider the nature of the misstatement and whether it is fair to project that misstatement.
- If the projected misstatement exceeds tolerable misstatement then sampling risk must be reassessed and further audit procedures must be considered.

When the auditors have tested a sample of items, they must then draw conclusions from that sample. The purpose of audit sampling is to enable conclusions to be drawn from an entire population on the basis of testing a sample drawn from it.

To begin with, the auditors must consider whether the items in question are **true misstatements**, as they defined them before the test. For example, when testing receivables, a sampled misposting between customer accounts will not affect whether the auditors conclude the valuation of total receivables is true and fair.

When the expected audit evidence regarding a specific sample item cannot be found, the auditor shall perform the procedure on a replacement item. In such cases, the item is not treated as a misstatement.

The **qualitative** aspects of misstatements are also considered, including the **nature and cause** of the misstatement. Auditors must also consider any possible effects the misstatement might have on **other parts of the audit** including the general effect on the financial statements and on the auditors' assessment of the accounting and internal control systems.

Where common features are discovered in misstatements, the auditors may decide to identify all items in the population that possess the common feature (eg, location), thereby producing a sub-population. Audit procedures could then be extended in this area.

On some occasions the auditor may decide that the misstatement is an anomaly.

Definition

Anomaly: A misstatement or deviation that is demonstrably not representative of misstatements or deviations in a population.

To be considered anomalous, the auditors have to be certain that the misstatements are not representative of the population. Extra work will be required to prove that a misstatement is an anomaly.

The auditors must project the misstatement results from the sample onto the relevant population. The auditors will **estimate the probable misstatement** in the population by extrapolating the misstatements found in the sample.

For substantive procedures, auditors will then **estimate any further misstatement** that might not have been detected because of the imprecision of the technique (in addition to consideration of the qualitative aspects of the errors).

Auditors must also consider the effect of the projected misstatement on other areas of the audit. The auditors should compare the projected population misstatement (net of adjustments made by the entity in the case of substantive procedures) to the tolerable misstatement taking account of other relevant audit procedures.

If the projected population misstatement exceeds or is close to tolerable misstatement, then the auditors must re-assess sampling risk. If it is unacceptable, they shall consider extending auditing procedures or performing alternative procedures. However, if after alternative procedures the auditors still believe the actual misstatement rate is higher than the tolerable misstatement rate, they should re-assess control risk if the test is a test of controls; if the test is a substantive procedures, they should consider whether the financial statements need to be adjusted.

This is an application of the concept of performance materiality, whereby the auditor assesses the materiality of a misstatement not just in line with the overall materiality level for the financial statements as a whole, but deploys materiality in the context of the specific misstatement or sample in question.

Context example: Context example: Drawing conclusions from sampling

Adrian carried out a supplier statement reconciliation on Peabody Ltd, testing the completeness and valuation assertions. This means that he compared the statements sent by suppliers to Peabody Ltd with the details on Peabody's own payables ledger. Tolerable misstatement has been set at £10,000. The sample was 10 payables ledger balances totalling £35,024 out of a total of £375,297. Adrian found that of these, eight reconciliations proved that the balance on the ledger was correct, one showed that an invoice had been misposted to a different supplier's account and one showed that an invoice had not been posted at all.

When considering the results of his sample, Adrian decided that he can disregard the misposting, as, although it means that two accounts were individually misstated, the overall balance was not affected by this mistake. In the case of the invoice that had simply been omitted in error however, Adrian had to conclude that this misstatement of £250, which does affect the overall total balance, could be repeated in the overall population with the potential for causing material misstatement. Adrian projected the total population misstatement based on the sample and compared the outcome with tolerable misstatement. In this case he found that the projected misstatement of £2,679 was considerably below the tolerable misstatement of £10,000 and concluded that no further action was required. He concluded from his testing that the trade payables balance in the financial statements was fairly stated.

Interactive question 3: Drawing conclusions from sampling

Danielle has carried out a receivables circularisation on Donothing plc to gain evidence about the existence and valuation of the receivables balance stated in the draft statement of financial position. Identify whether the following conclusions drawn by her are correct or not.

	True/False
An amount disagreed by Lazy Limited because a payment for an invoice had been despatched two days before the year end and received by Donothing plc shortly after the year end, did not constitute a misstatement for the purposes of drawing a conclusion for the whole population.	
An amount disagreed by Sloth Limited because a credit note had been issued by Donothing plc a month before the year end did not constitute a misstatement for the purposes of drawing a conclusion for the whole population.	
An amount disagreed by Busy Limited because they had paid the balance some time earlier, which further enquiry revealed had been posted to a different customer account, did constitute a misstatement for the purposes of drawing a conclusion for the whole population.	

See **Answer** at the end of this chapter.

7 Evaluation of misstatements

Section overview

8

- ISA (UK) 450, Evaluation of Misstatements Identified During the Audit requires the auditor to evaluate the effect of identified misstatements on the audit and evaluate the effect of any uncorrected misstatements on the financial statements.
- All non-trivial misstatements must be communicated to management and if uncorrected, to those charged with governance.

The auditor is required to **evaluate the effect of identified misstatements on the audit** in ISA (UK) 450, *Evaluation of Misstatements Identified during the Audit*. Under this ISA, the auditor must also **evaluate the effect of any uncorrected misstatements on the financial statements**.

During the audit, auditors must accumulate any non-trivial misstatements identified and determine whether the audit plan or overall audit strategy need to be revised based on these. Additional audit procedures shall be performed where management has examined and corrected balances at the auditor's request.

The auditor is required to communicate all misstatements on a timely basis to the appropriate level of management and request that management corrects the misstatements. The auditor is required to request a written representation from management whether they believe the effects of uncorrected misstatements to be immaterial to the financial statements as a whole. If management have corrected material misstatements, then doing this may help them to fulfil their governance responsibilities, including reviewing the effectiveness of internal control.

If management refuses to correct some or all of the misstatements then the auditor shall:

- obtain an understanding of management's **reasons** for not making the corrections
- determine whether uncorrected misstatements are **material** individually or in aggregate
- **communicate** individual uncorrected misstatements to those charged with governance and request that these be corrected, mentioning any effect on the opinion in the auditor's report
- request a **written representation** from management (and if appropriate those charged with governance) that they believe the effects of the uncorrected misstatements are immaterial, individually and in aggregate, to the financial statements as a whole

In determining whether uncorrected misstatements are material, the auditor must consider the **size** and **nature** of the misstatements, along with the particular **circumstances** of their occurrence. Certain circumstances may cause the auditor to evaluate misstatements as material, even if they are lower than materiality for the financial statements as a whole. Examples of circumstances include, but are not limited to, the extent to which the misstatement:

- affects compliance with regulatory requirements
- affects compliance with debt covenants or other regulatory requirements
- masks a change in earnings or other trends
- affects ratios used to evaluate the entity's financial position, results of operations or cash flows
- increases management's compensation, for example by ensuring the requirements for the award of bonuses are met

Interactive question 4: Material misstatements

Which two of the following should be determined as material uncorrected misstatements?

A An isolated misposting between two supplier accounts which is below materiality

B A misstatement which is below materiality and results in directors' bonus targets being met

C An immaterial misstatement of assets which results in a debt covenant not being breached

D The monthly bank reconciliation was not prepared in August as the cashier was on holiday

See **Answer** at the end of this chapter.

Summary

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Further question practice

Knowledge diagnostic

Before you move on to question practice, complete the following knowledge diagnostic and check you are able to confirm you possess the following essential learning from this chapter. It not, you are advised to revisit the relevant learning from the topic indicated.

Confirm your learning	Yes/No
(a) Can you define audit data analytics? (Topic 1)	
(a) Can you explain the procedures by which audit evidence may be obtained? (Topic 1)	
(a) Can you explain the four principal methods for auditing accounting estimates? (Topic 1)	
(a) Can you define sampling risk? (Topic 2)	
(a) Do you understand the factors influencing sample sizes and whether they increase or decrease sample size? (Topic 2)	

Chapter Self-test question practice

Aim to complete all self-test questions at the end of this chapter. Once completed, attempt all questions in Chapter 11 of the Assurance Question Bank and refer back to the learning in this chapter for any questions which you do not answer correctly and the suggested solution has not provided sufficient explanation to answer all your queries. Once you have attempted these questions, you can move onto the next chapter, Written representations.

Technical references

1 Evidence

- Procedures to obtain evidence – **ISA (UK) 500.A14 – A25**
- Analytical procedures – **ISA (UK) 520, ISA (UK) 315**.
- Accounting estimates – **ISA (UK) 540.13**

2 Selecting items to test

- The concept of sampling – **ISA (UK) 500.A54 + ISA (UK) 530.4 – 5**
- Design of the sample – **ISA (UK) 530.5 – 8, Appx 2, Appx 3**
- Selecting the sample – **ISA (UK) 530 Appx 1**

3 Drawing conclusions from sampling – ISA (UK) 530.14, A18 – A23

4 Evaluation of misstatements – ISA (UK) 450.5 – 15 + ISA (UK) 450.A16

Self-test questions

Answer the following questions.

- Which one of the following procedures would give the most persuasive evidence that a control operated as the assurance providers had been advised?

  A Inspection of the controls handbook

  B Inquiry of the staff operating the control

  C Observation of the staff operating the control

  D Reperformance of the control by audit staff

. Indicate the purpose of the primary test for each type of account in directional testing.

	Overstatement/Understatement
Assets	
Liabilities	
Income	
Expense	

. Identify the significant relationships in the list of items below

(a) Payables	(b) Interest	(c) Purchases	(d) Revenue
(e) Amortisation	(f) Loans	(g) Receivables	(h) Intangibles

. Identify whether the following statements are true or false

	True/False
The risk that the auditor's conclusion, based on a sample, may be different from the conclusion if the entire population were subjected to the same audit procedure is sampling risk.	
The risk that the auditor might use inappropriate procedures or might misinterpret audit evidence and thus fail to recognise a misstatement or deviation is non-sampling risk.	

. Identify whether the following examples of sample selection are random, haphazard or systematic.

	Random/Haphazard/Systematic
(Barry is selecting a sample from the list of receivables balances. He selects the second, and thereafter every 7th balance.	
Carol is selecting a number of purchase invoices to carry out a directional test. She selects them by flicking through the files and selecting an invoice occasionally.	

Now go back to the Introduction and ensure that you have achieved the Learning outcomes listed for this chapter.

Answers to Interactive questions

Answer to Interactive question 1

B Inspection of a sales invoice

A sales invoice is an internally generated document and therefore provides a poor source of evidence. It would be better to obtain information about sales from the customers.

Answer to Interactive question 2

	Increase/Decrease
Decrease in the assessed level of tolerable misstatement.	Increase
Increase in the assessed risk level.	Increase
Discovery of more misstatements than were anticipated during testing.	Increase

They would all cause the sample size to increase.

Answer to Interactive question 3

	True/False
An amount disagreed by Lazy Limited because a payment for an invoice had been despatched two days before the year end and received by Donothing plc shortly after the year end, did not constitute a misstatement for the purposes of drawing a conclusion for the whole population.	True
An amount disagreed by Sloth Limited because a credit note had been issued by Donothing plc a month before the year end did not constitute a misstatement for the purposes of drawing a conclusion for the whole population.	False
An amount disagreed by Busy Limited because they had paid the balance some time earlier, which further enquiry revealed had been posted to a different customer account, did constitute a misstatement for the purposes of drawing a conclusion for the whole population.	False

True – this is just a timing difference.

False – this indicates that the credit note may not have been processed to the receivables ledger, which would be an error that could also be true of other potential credits due on the ledger.

False– this error does not affect the overall balance on the ledger.

Answer to Interactive question 4

B A misstatement which is below materiality and results in directors' bonus targets being met

C An immaterial misstatement of assets which results in a debt covenant not being breached

Although these two items are below materiality, the particular circumstances surrounding their occurrence make them material misstatements. The last item relates to a test of controls.

Answers to Self-test questions

1 Correct answer(s):

D Reperformance of the control by audit staff

Reperformance by the auditor would give the strongest evidence of this being the case

	Overstatement/Understatement
Assets	Overstatement
Liabilities	Understatement
Income	Understatement
Expense	Overstatement

2 (a) and (c)

(b) and (f)

(d) and (g)

(e) and (h)

	True/False
The risk that the auditor's conclusion, based on a sample, may be different from the conclusion if the entire population were subjected to the same audit procedure is sampling risk.	True
The risk that the auditor might use inappropriate procedures or might misinterpret audit evidence and thus fail to recognise a misstatement or deviation is non-sampling risk.	True

	Random/Haphazard/Systematic
(Barry is selecting a sample from the list of receivables balances. He selects the second, and thereafter every 7th balance.	Systematic
Carol is selecting a number of purchase invoices to carry out a directional test. She selects them by flicking through the files and selecting an invoice occasionally.	Haphazard

Appendix

Tax Tables FA2020

Syllabus area: Administration

SUBMISSION DATES

Submission dates for 2020/21 personal self-assessment tax returns

Return filed online	Later of: 31 January 2022 3 months from the date of issue of return
Paper returns	Later of: 31 October 2021 3 months from the date of issue of return

Submission dates for corporation tax returns

Must be filed by 12 months from the end of the period of account.

Submission dates for PAYE information: Real Time Information

Information	Filing date
Full Payment Submission (FPS)	On or before the day the employee is paid
P60 (to employees)	31 May following the tax year end
P11D	6 July following the tax year end

PAYMENT DATES

Payment dates for income tax

Payment	Filing date
First interim payment (1)	31 January in the tax year
Second interim payment (1)	31 July following the tax year end
Balancing payment	31 January following the tax year end

(1) Interim payments are not required if the tax paid by assessment for the previous year was less than:

£1,000; or

20% of the total tax liability (income tax and Class 4)

Payment dates for capital gains tax

Capital gains tax is payable by 31 January following the tax year end.

Payment dates for corporation tax	
Corporation tax	Nine months and one day after the end of an accounting period
Corporation tax by instalments – large companies	The 14th day of months 7, 10, 13 and 16 counted from the start of a 12-month accounting period
Corporation tax by instalments – very large companies	The 14th day of months 3, 6, 9 and 12 counted from the start of a 12-month accounting period

Payment dates for VAT

	Due date
Electronic payment	7 calendar days after the last day of the month following the end of the return period
Direct debit payment	Collected automatically 3 working days after electronic payment due date

MAIN PENALTY PROVISIONS

PENALTIES FOR INCORRECT RETURNS

The penalties are a percentage of the potential lost revenue

Reason for penalty	Maximum penalty	Minimum penalty with unprompted disclosure	Minimum penalty with prompted disclosure
Careless action	30%	Nil	15%
Deliberate but not concealed action	70%	20%	35%
Deliberate and concealed action	100%	30%	50%

PENALTIES FOR FAILURE TO NOTIFY

Failures to notify chargeability to tax, or liability to register for tax that leads to a loss of tax will result in a penalty. The penalties are a percentage of the potential lost revenue.

Reason for penalty	Maximum penalty	Minimum penalty with unprompted disclosure		Minimum penalty with prompted disclosure	
Deliberate and concealed action	100%		30%		50%
Deliberate but not concealed action	70%		20%		35%
		>12m	<12m	>12m	<12m
Any other case	30%	10%	Nil	20%	10%

COMPANIES: PENALTIES

Offence	Maximum Penalty
Failure to notify chargeability within 12 months of end of accounting period	See above: penalties for failure to notify

Corporation tax: penalties for late filing of a corporation tax return

Offence	Penalty(1)
Late return, up to 3 months late	£100 fixed penalty, or £500 for persistent failure
Return more than 3 months late	£200 fixed penalty, or £1,000 for persistent failure
Return filed more than 18 months but less than 24 months after end of return period	Tax geared penalty of 10% of tax unpaid 18 months after end of return period
Return filed more than 24 months after end of return period	Tax geared penalty of 20% of tax unpaid 18 months after end of return period

(1) The tax geared penalty is charged in addition to the fixed penalty but only one of each type of penalty is charged.

INDIVIDUALS: PENALTIES

Offence	Maximum Penalty
Failure to notify chargeability by 5 October following tax year end	See above: penalties for failure to notify
Late payment of income tax or capital gains tax: (1)	
Unpaid 30 days after payment due date	5% of tax unpaid
Unpaid 6 months after payment due date	Further 5% of tax unpaid
Unpaid 12 months after payment due date	Further 5% of tax unpaid

(1) Late payment penalties do not apply to payments on account.

Income tax and CGT: penalties for late filing of a self-assessment return

Offence	Maximum Penalty
Late return	Immediate £100 fixed penalty
Return more than 3 months late	Daily fixed penalties of up to £10 per day for maximum 90 days
Return more than 6 months but less than 12 months late	Further tax geared penalty of 5% of tax due (minimum £300)
Return 12 months late	Further tax geared penalties apply (minimum £300): 100% if deliberate and concealed(1) 70% if deliberate but not concealed(1) 5% in all other cases

(1) These tax geared penalties are reduced for disclosure as per penalties for incorrect returns.

PAYE: penalties for late returns/ submissions

Number of employees	Monthly penalty
1 to 9	£100
10 to 49	£200
50 to 249	£300
250 or more	£400

If the form is more than three months late, an additional penalty is due of 5% of the tax and NIC that should have been reported.

Additionally, there is a £300 penalty per late P11D return, with an extra £60 per day charged if the delay continues.

PAYE: penalties for late payment

	No of late payments	% of tax unpaid(1)
Penalties for late payment of in-year PAYE depend on the number of defaults in the tax year	1st	nil
	2nd, 3rd & 4th	1%
	5th, 6th & 7th	2%
	8th, 9th & 10th	3%
	11th or more	4%
Where a penalty has been imposed and the tax remains unpaid at 6 months		5%(2)
Where a penalty has been imposed and the tax		5%(2)

remains unpaid at 12 months

(1) The percentage penalty is applied to the total amount that is late in the relevant tax month.

(2) The 6 month and the further 12 month penalties are in addition to the initial penalty for late payment.

VAT: penalties

Offence	Maximum Penalty
Failure to notify liability for registration or change in nature of supplies by person exempted from registration	See above: penalties for failure to notify

VAT: late payment or late filing – default surcharge

Default involving late payment of VAT in the surcharge period[1]	Surcharge as a percentage of the VAT outstanding at the due date
First	2%[2]
Second	5%[2]
Third	10%[3]
Fourth	15%[3]

(1) Default if late payment of VAT or filing of VAT return and surcharge liability notice issued, but default surcharge only applies on late payment.

(2) No surcharge if it would be less than £400.

(3) Minimum £30 payable.

VAT errors

An error made on a VAT return can be corrected on the next return provided it was not deliberate and does not exceed the greater of:

- £10,000 (net under-declaration minus over-declaration); or
- 1% x net VAT turnover for return period (maximum £50,000)

Alternatively, a 'small' error which is not deliberate may be corrected via the submission of form VAT652. Errors which are not 'small' or errors which are deliberate should be notified to HMRC on form VAT652.

RECORD KEEPING PENALTY

Offence	Maximum Penalty
Failure to keep and retain tax records	£3,000 per tax year / accounting period

INCOME TAX RATES: 2020/21

	Rate	Taxable income band
Main rates		
Basic rate	20%	£1 – £37,500
Higher rate	40%	£37,501 – £150,000
Additional rate	45%	Over £150,000
Savings rates		
Starting rate for savings	0%	£1 - £5,000
Savings income nil rate	0%	First £1,000 or £500
Savings basic rate	20%	Otherwise chargeable at basic rate

	Rate	Taxable income band
Savings higher rate	40%	Otherwise chargeable at higher rate
Savings additional rate	45%	Otherwise chargeable at additional rate
Dividends rates		
Dividend nil rate	0%	First £2,000
Dividend ordinary rate	7.5%	Otherwise chargeable at basic rate
Dividend upper rate	32.5%	Otherwise chargeable at higher rate
Dividend additional rate	38.1%	Otherwise chargeable at additional rate
Default rates		
Default basic rate	20%	
Default higher rate	40%	
Default additional rate	45%	

INCOME TAX RELIEFS	**2020/21**
Personal allowance	£12,500

CGT RATES

	2020/21
Gains falling within the remaining basic rate band	10%
Gains exceeding the basic rate band	20%

CORPORATION TAX RATES

	FY 2020
Tax rate	19%
Augmented profits limit for corporation tax payment dates – large companies	£1,500,000
Augmented profits limit for corporation tax payment dates – very large companies	£20,000,000

NATIONAL INSURANCE CONTRIBUTIONS

	2020/21		
NIC CLASS 1	**Annual**	**Monthly**	**Weekly**
Primary threshold (PT)	£9,500	£792	£183
Secondary threshold (ST)	£8,788	£732	£169
Upper earnings limit (UEL)	£50,000	£4,167	£962
Apprentice upper secondary threshold (AUST) for under 25s	£50,000	£4,167	£962
Upper secondary threshold (UST) for under 21s	£50,000	£4,167	£962

NIC CLASS 1		2020/21 Annual	Monthly	Weekly
Employment allowance (per year, per employer)	£4,000			
Class 1 Primary contributions on earnings between PT & UEL	12%			
Class 1 Primary contributions on earnings above UEL	2%			
Class 1 Secondary contributions on earnings above ST where employee aged 21 or over and not an apprentice under the age of 25	13.8%			
Class 1 Secondary contributions on earnings between ST & AUST for apprentices under the age of 25	0%			
Class 1 Secondary contributions on earnings above AUST for apprentices under the age of 25	13.8%			
Class 1 Secondary contributions on earnings between ST & UST for employees under the age of 21	0%			
Class 1 Secondary contributions on earnings above UST for employees under the age of 21	13.8%			
Class 1A contributions	13.8%			

	2020/21
NIC CLASS 2	
Normal rate	£3.05 pw
Small profits threshold	£6,475 pa
NIC CLASS 4	
Annual lower profits limit (LPL)	£9,500
Annual upper profits limit (UPL)	£50,000
Percentage rate between LPL & UPL	9%
Percentage rate above UPL	2%
VAT	
Standard rate of VAT	20%
Reduced rate of VAT	5%

Syllabus Area: Income Tax & NIC

INCOME TAX RATES: 2020/21	Rate	Taxable income band
Main rates		
Basic rate	20%	£1 – £37,500
Higher rate	40%	£37,501 – £150,000
Additional rate	45%	Over £150,000
Savings rates		

INCOME TAX RATES: 2020/21	Rate	Taxable income band
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Dividend upper rate	32.5%	Otherwise chargeable at higher rate
Dividend additional rate	38.1%	Otherwise chargeable at additional rate
Default rates		
Default basic rate	20%	
Default higher rate	40%	
Default additional rate	45%	

INCOME TAX RELIEFS	2020/21
Personal allowance[1]	£12,500
Marriage allowance[2]	£1,250

(1) The personal allowance of any individual with adjusted net income above £100,000 is reduced by £1 for every £2 of adjusted net income above the £100,000 limit.

(2) A spouse or civil partner who is a basic rate taxpayer or who has income of less than the personal allowance is allowed to transfer £1,250 of their personal allowance (ie 10% rounded up to the next £10) to their spouse/civil partner provided the recipient spouse is a basic rate taxpayer.

CAPITAL ALLOWANCES

First year allowances available

100% on new and unused zero emissions goods vehicles

100% on new and unused low emission cars ie electrically propelled or with CO_2 emissions of not more than 50 g/km

100% on electric vehicle charging points

Annual investment allowance

£200,000 pa of expenditure incurred by any business on certain plant and machinery from 1 January 2021.

Writing down allowances

18% pa in the main pool

COMPANY VANS, CARS AND FUEL

Van scale charge

No charge applies if there is insignificant private use

£2,792 if van has zero CO_2 emissions and £3,490 if it has CO_2 emissions

Additional £666 if private fuel provided for the van

Company cars – cash equivalent	
Zero emissions cars	0% of list price

Company cars – cash equivalent

Hybrid cars with emissions 1-50g/km	2% of list price for cars with a battery range of >130 miles
	5% of list price for cars with a battery range of 70-129 miles
	8% of list price for cars with a battery range of 40-69 miles
	12% of list price for cars with a battery range of 30-39 miles
	14% of list price for cars with a battery range of <30 miles
Other cars	15% of list price for cars emitting 51-54g/km
	16% of list price for cars emitting 55-59g/km
	17% of list price for cars emitting 60-64g/km
	18% of list price for cars emitting 65-69g/km
	19% of list price for cars emitting 70-74g/km
	20% of list price for cars emitting 75-79g/km
	Increased by 1% per 5g/km over the 75g/km relevant threshold

Relevant % is reduced by 2% for cars first registered from 6 April 2020

Capped at 37% of list price (ie emissions of 160g/km or more for cars first registered before 6 April 2020 and 170g/km for cars first registered from 6 April 2020)

Diesel cars that meet the Real Driving Emissions Step 2 (RDE2) standard are treated as above, all other diesel cars have a 4% supplement added to the relevant percentage (subject to 37% cap)

Private fuel provided for company car

£24,500 x company car %

PAYE CODES

L	tax code with personal allowance
M	tax code with personal allowance plus claiming marriage allowance
N	tax code with personal allowance less surrendered marriage allowance
S	income taxed at Scottish rate of income tax
C	income taxed at Welsh rate of income tax
K	total allowances are less than total deductions
T	tax code includes other calculations to work the personal allowance, for example it has been reduced because estimated annual income is more than £100,000

NATIONAL INSURANCE CONTRIBUTIONS

	2020/21		
NIC CLASS 1 CONTRIBUTIONS	**Annual**	**Monthly**	**Weekly**
Primary threshold (PT)	£9,500	£792	£183
Secondary threshold (ST)	£8,788	£732	£169
Upper earnings limit (UEL)	£50,000	£4,167	£962

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Class 1 Secondary contributions on earnings above UST for employees under the age of 21	13.8%			
Class 1A contributions	13.8%			

NIC CLASS 2 CONTRIBUTIONS	2020/21
Normal rate	£3.05 pw
Small profits threshold	£6,475 pa
NIC CLASS 4 CONTRIBUTIONS	
Annual lower profits limit (LPL)	£9,500
Annual upper profits limit (UPL)	£50,000
Percentage rate between LPL & UPL	9%
Percentage rate above UPL	2%

Syllabus area: Capital Gains

	2020/21
Annual exempt amount	£12,300
Gains falling within the remaining basic rate band	10%
Gains exceeding the basic rate band	20%
Basic rate band	£1 – £37,500

Syllabus area: Corporation tax

	FY 2020
Tax rate	19%
Augmented profits limit for corporation tax payment dates – large companies	£1,500,000
Augmented profits limit for corporation tax payment dates – very large companies	£20,000,000

CAPITAL ALLOWANCES

First year allowances available

100% on new and unused zero emissions goods vehicles

100% on new and unused low emission cars ie electrically propelled or with CO_2 emissions of not more than 50 g/km

100% on electric vehicle charging points

Annual investment allowance

£200,000 pa of expenditure incurred by any business on certain plant and machinery from 1 January 2021.

Writing down allowances

18% pa in the main pool

PAYMENT DATES

Payment dates for corporation tax	
Corporation tax	Nine months and one day after the end of an accounting period
Corporation tax by instalments – large companies	The 14th day of months 7, 10, 13 and 16 counted from the start of a 12-month accounting period
Corporation tax by instalments – very large companies	The 14th day of months 3, 6, 9 and 12 counted from the start of a 12-month accounting period

Syllabus area: Value Added Tax

VAT

Standard rate		20%
Reduced rate		5%
Annual registration limit	From 1 April 2017	£85,000
Deregistration limit	From 1 April 2017	£83,000
VAT fraction (standard rated)		1/6

Cash accounting	**£**
Turnover threshold to join scheme	1,350,000
Turnover threshold to leave scheme	1,600,000
Annual accounting	
Turnover threshold to join scheme	1,350,000
Turnover threshold to leave scheme	1,600,000

Flat rate scheme	
Annual taxable turnover limit (excluding VAT) to join scheme	150,000
Annual total income (including VAT) to leave scheme	230,000

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